

Office of Chief Counsel
Internal Revenue Service

memorandum

CC: [REDACTED]: [REDACTED]: [REDACTED]: TL-N-1147-99
[REDACTED]

date: APR 09 1999

to: Chief, Examination Division, [REDACTED] District
Attn: [REDACTED]

from: District Counsel, [REDACTED] District, [REDACTED]

subject: [REDACTED]
Request For Advice - [REDACTED] Contract

DISCLOSURE STATEMENT

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to attorney-client and deliberative process privileges and if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the Examination or Appeals recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to Examination, Appeals, or other persons beyond those specifically indicated in this statement. This advice may not be disclosed to taxpayers or their representatives.

This advice is not binding on Examination or Appeals and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memorandum is in response to your request for preliminary advice concerning the possible classifications of certain expenses incurred by the [REDACTED] under the [REDACTED] Project Contract. You requested that we furnish preliminary legal advice on this issue, prior to factual development, solely to provide some initial guidance to the examining agent in the conduct of the audit. This response should only be considered as an aid in identifying potential issues for further development. As the facts surrounding this potential issue have not been developed, we can only provide you with a discussion of potentially relevant

legal considerations and make recommendations regarding factual development. Accordingly, we are not providing any opinion with respect to your request. However, we have supplied a discussion, to the extent possible, based on the information furnished and pointed out the areas in which additional factual development is required.

ISSUES

1. Whether the expenses incurred by the [REDACTED] which were contracted for by [REDACTED], a wholly owned subsidiary of [REDACTED], constitute nondeductible start-up costs pursuant to I.R.C. § 195 during the period from [REDACTED] to [REDACTED].

2. Whether the expenses incurred by the [REDACTED] after [REDACTED] constitute "precontract activity."

FACTS

During [REDACTED] and [REDACTED], the [REDACTED] ([REDACTED]) conducted research and development activities related to [REDACTED].

On [REDACTED], [REDACTED] was incorporated as a wholly owned subsidiary of [REDACTED] ([REDACTED]). [REDACTED]

On [REDACTED], [REDACTED] and [REDACTED] entered into a contract whereby [REDACTED] would purchase the [REDACTED] portion of the System.

On [REDACTED], [REDACTED] was formed.¹ Also on this date, [REDACTED] and [REDACTED] enter into a contract whereby [REDACTED] sold the [REDACTED] to the [REDACTED].

The [REDACTED] consists of [REDACTED] which were to be constructed by [REDACTED].

DISCUSSION

Issue 1.

I.R.C. § 195(a) of the Code provides that, except as

¹ The relationship of the initial [REDACTED] corporation to [REDACTED] was not provided. Nor is it clear what was sold by [REDACTED] to either [REDACTED] or [REDACTED]

otherwise provided in section 195, no deduction is allowed for start-up expenditures.

Section 195(c)(1)(A) defines the term "start-up expenditures" as any amount paid or incurred in connection with (1) investigating the creation or acquisition of an active trade or business, or (2) creating an active trade or business, or (3) engaging in any activity for profit and for the production of income before the day on which the active trade or business begins in anticipation of the activity becoming an active trade or business. Section 195(c)(1)(B) provides that the amount paid or incurred in one of these manners is a start-up expenditure only if the amount would be deductible if paid or incurred in connection with the operation of an existing trade or business.

In the case of an existing business, pre-opening or start-up expenses do not include business expenses paid in connection with the expansion of a business. Expenses associated with the expansion of an existing business are currently deductible.

Whether a business is an expansion of an existing trade or business or new trade or business depends on the facts and circumstances of each case. S. Rep No. 1036, 96th Cong., 2d Sess. 12 (1980); See also Higgins v. Commissioner, 312 U.S. 212, 217 (1941). [REDACTED], (b)(5)(AC), (b)(5)(DP)

[REDACTED]. However, the Service applies the law defining when a trade or business begins for a new enterprise or entity to determine the most likely approach for answering this question. (See, e.g., IRS Letter Ruling 9331001.)

The leading case defining when a trade or business begins is Richmond Television Corp. v. United States, 345 F.2d 901 (4th Cir. 1965). In Richmond Television, the taxpayer was a corporation organized to operate a television station. The court held that the taxpayer was not a "going concern" until the broadcasting license was issued and broadcasting commenced. Because the costs of training prospective employees were incurred before the license was issued and before broadcasting commenced, the court held that the costs were capital expenditures and were not deductible under section 162(a) of the Code.²

² The United States Tax Court and majority of the federal circuits that have considered this issue follow the "going concern" test of Richmond Television. See, e.g., Goodwin v. Commissioner, 75 T.C. 424 (1980), aff'd, 691 F.2d 490 (3d Cir. 1982); Madison Gas & Elec. Co. v. Commissioner, 72 T.C. 521 (1979), aff'd, 633 F.2d 512 (7th Cir. 1980); and Hoopengartner v.

The crucial prerequisite for deductibility of trade or business expenses under section 162 is that the enterprise incurring them must be beyond the point of mere preparation and actually be engaged in the primary activities intended. Applying this rule to the question of when an entity already engaged in a trade or business begins a new trade or business, it is appropriate to look for a change in the nature of the activities engaged in by the entity.³

In the current case, sufficient facts have not been set forth to determine whether the research and development expenses of [REDACTED] are an expansion of [REDACTED]'s existing trade or business or constitute a new trade or business. The facts do not state what the activities of [REDACTED] were before and after the [REDACTED] or otherwise provide any insight into the change of activities of the corporation. (b)(5)(AC)

[REDACTED]

. Accordingly, we can offer no opinion on whether the activities constitute a new trade or business.

Issue 2.

If costs are incurred in a taxable year prior to the year a long-term contract is entered into, then the costs are to be capitalized in the year in which they are incurred if two

Commissioner, 80 T.C. 538 (1983), aff'd, 699 F.2d 450 (8th Cir. 1983).

³ For example, in Cleveland Elec. Illuminating Co. v. United States, 7 Cl. Ct. 220, 228-29 (1985), the court noted that nuclear generation of electricity differs substantially from the production of electricity in conventional fossil fuel plants. The employees must be trained to a higher degree. Heat is produced by different means. Finally, support systems are required at a nuclear reactor that are not required for conventional plants. Therefore, the court concluded that the training expenses incurred in connection with the opening of the nuclear plant should be capitalized as a one-time expenditure necessary to begin a new business. See also Radio station WBIR v. Commissioner, 31 T.C. 803 (1959) (holding that the operation of a radio station is not the same business as the operation of a television station).

conditions are met. First, it must have been reasonably foreseeable at the time the costs were incurred that they relate to a long-term contract that will be entered into during a future year. Second, the costs must be of a nature such that they would otherwise be allocable to the contract under I.R.C. § 460(c). Notice 89-15, 89-1 C.B. 634, Q&A-29.

In the current case, no facts were set forth from which it could be determined whether or not any costs were incurred which were "reasonably foreseeable" at the time to relate to a future long-term contract. Although the facts show that a contract was ultimately entered, there were no facts presented indicating whether it was foreseeable at the time the costs were incurred that a contract would be entered. (b)(5)(AC)

[REDACTED]

Therefore, we can not reach any conclusion regarding the first condition.

The second condition provides that the costs must be such that they would otherwise be allocable to the contract under I.R.C. § 460(c). For long-term contracts, all costs (including research and experimental costs) that either directly benefit or are incurred by reason of contract activities are to be allocated to the contract under rules that originally applied only to extended period long-term contracts. I.R.C. § 460(c)(1). However, specifically exempted from allocation are "independent research and development" costs that are not (1) incurred under research and development agreements, or (2) directly attributable to a long-term contract existing when the expenses were incurred. I.R.C. § 460(c)(5).

Thus, if the research and development costs incurred by [REDACTED] qualify as "independent research and development" costs under I.R.C. § 460(c)(5), then the costs would not otherwise be allocable to the contract and the second condition, set forth above, would not be met. Based on the facts provided, it appears that [REDACTED], (b)(5)(DP)

[REDACTED]

Accordingly, the costs incurred prior to that date may be independent research and development costs under I.R.C. § 460(c)(5) and may not be allocable to the long-term contract.

[REDACTED], (b)(5)(AC)

[REDACTED]

. (b)(5)(AC)

As a starting point in your [REDACTED] (b)(5)(AC)

[REDACTED]. Please note, we consider the statements of law expressed in this memorandum to be significant large case advice. Therefore, we request that you refrain from acting on this memorandum for ten (10) working days to allow the Assistant Chief Counsel (Field Service) an opportunity to comment. If you have any questions regarding the above, please contact me at ([REDACTED]) [REDACTED].

[REDACTED]
District Counsel

By: [REDACTED]
[REDACTED]
Attorney

cc: Regional Counsel, [REDACTED]
Office of Assistant Chief Counsel, Field Service